

(2) *Applicable family member.* An applicable family member is, with respect to any transferor—

- (i) The transferor's spouse;
- (ii) Any ancestor of the transferor or the transferor's spouse; and
- (iii) The spouse of any such ancestor.

(3) *Relationship by adoption.* For purposes of section 2701, any relationship by legal adoption is the same as a relationship by blood.

(e) *Examples.* The following examples illustrate provisions of this section:

Example 1. P, an individual, holds all the outstanding stock of X Corporation. Assume the fair market value of P's interest in X immediately prior to the transfer is \$1.5 million. X is recapitalized so that P holds 1,000 shares of \$1,000 par value preferred stock bearing an annual cumulative dividend of \$100 per share (the aggregate fair market value of which is assumed to be \$1 million) and 1,000 shares of voting common stock. P transfers the common stock to P's child. Section 2701 applies to the transfer because P has transferred an equity interest (the common stock) to a member of P's family and immediately thereafter holds an applicable retained interest (the preferred stock). P's right to receive annual cumulative dividends is a qualified payment right and is valued for purposes of section 2701 at its fair market value of \$1,000,000. The amount of P's gift, determined using the subtraction method of § 25.2701-3, is \$500,000 (\$1,500,000 minus \$1,000,000).

Example 2. The facts are the same as in *Example 1*, except that the preferred dividend right is noncumulative. Under § 25.2701-2, P's preferred dividend right is valued at zero because it is a distribution right in a controlled entity, but is not a qualified payment right. All of P's other rights in the preferred stock are valued as if P's dividend right does not exist but otherwise without regard to section 2701. The amount of P's gift, determined using the subtraction method, is \$1,500,000 (\$1,500,000 minus \$0). P may elect, however, to treat the dividend right as a qualified payment right as provided in § 25.2701-2(c)(2).

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§ 25.2701-2 Special valuation rules for applicable retained interests.

(a) *In general.* In determining the amount of a gift under § 25.2701-3, the value of any applicable retained interest (as defined in paragraph (b)(1) of this section) held by the transferor or by an applicable family member is de-

termined using the rules of chapter 12, with the modifications prescribed by this section. See § 25.2701-6 regarding the indirect holding of interests.

(1) *Valuing an extraordinary payment right.* Any extraordinary payment right (as defined in paragraph (b)(2) of this section) is valued at zero.

(2) *Valuing a distribution right.* Any distribution right (as defined in paragraph (b)(3) of this section) in a controlled entity is valued at zero, unless it is a qualified payment right (as defined in paragraph (b)(6) of this section). Controlled entity is defined in paragraph (b)(5) of this section.

(3) *Special rule for valuing a qualified payment right held in conjunction with an extraordinary payment right.* If an applicable retained interest confers a qualified payment right and one or more extraordinary payment rights, the value of all these rights is determined by assuming that each extraordinary payment right is exercised in a manner that results in the lowest total value being determined for all the rights, using a consistent set of assumptions and giving due regard to the entity's net worth, prospective earning power, and other relevant factors (the "lower of" valuation rule). See §§ 20.2031-2(f) and 20.2031-3 for rules relating to the valuation of business interests generally.

(4) *Valuing other rights.* Any other right (including a qualified payment right not subject to the prior paragraph) is valued as if any right valued at zero does not exist and as if any right valued under the lower of rule is exercised in a manner consistent with the assumptions of that rule but otherwise without regard to section 2701. Thus, if an applicable retained interest carries no rights that are valued at zero or under the lower of rule, the value of the interest for purposes of section 2701 is its fair market value.

(5) *Example.* The following example illustrates rules of this paragraph (a).

Example. P, an individual, holds all 1,000 shares of X Corporation's \$1,000 par value preferred stock bearing an annual cumulative dividend of \$100 per share and holds all 1,000 shares of X's voting common stock. P has the right to put all the preferred stock to X at any time for \$900,000. P transfers the common stock to P's child and immediately thereafter holds the preferred stock. Assume

that at the time of the transfer, the fair market value of X is \$1,500,000, and the fair market value of P's annual cumulative dividend right is \$1,000,000. Because the preferred stock confers both an extraordinary payment right (the put right) and a qualified payment right (i.e., the right to receive cumulative dividends), the lower of rule applies and the value of these rights is determined as if the put right will be exercised in a manner that results in the lowest total value being determined for the rights (in this case, by assuming that the put will be exercised immediately). The value of P's preferred stock is \$900,000 (the lower of \$1,000,000 or \$900,000). The amount of the gift is \$600,000 (\$1,500,000 minus \$900,000).

(b) *Definitions*—(1) *Applicable retained interest*. An applicable retained interest is any equity interest in a corporation or partnership with respect to which there is either—

(i) An extraordinary payment right (as defined in paragraph (b)(2) of this section), or

(ii) In the case of a controlled entity (as defined in paragraph (b)(5) of this section), a distribution right (as defined in paragraph (b)(3) of this section).

(2) *Extraordinary payment right*. Except as provided in paragraph (b)(4) of this section, an extraordinary payment right is any put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or nonexercise of which affects the value of the transferred interest. A call right includes any warrant, option, or other right to acquire one or more equity interests.

(3) *Distribution right*. A distribution right is the right to receive distributions with respect to an equity interest. A distribution right does not include—

(i) Any right to receive distributions with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest;

(ii) Any extraordinary payment right; or

(iii) Any right described in paragraph (b)(4) of this section.

(4) *Rights that are not extraordinary payment rights or distribution rights*. Mandatory payment rights, liquidation participation rights, rights to guaranteed payments of a fixed amount under section 707(c), and non-lapsing conver-

sion rights are neither extraordinary payment rights nor distribution rights.

(i) *Mandatory payment right*. A mandatory payment right is a right to receive a payment required to be made at a specific time for a specific amount. For example, a mandatory redemption right in preferred stock requiring that the stock be redeemed at its fixed par value on a date certain is a mandatory payment right and therefore not an extraordinary payment right or a distribution right. A right to receive a specific amount on the death of the holder is a mandatory payment right.

(ii) *Liquidation participation rights*. A liquidation participation right is a right to participate in a liquidating distribution. If the transferor, members of the transferor's family, or applicable family members have the ability to compel liquidation, the liquidation participation right is valued as if the ability to compel liquidation—

(A) Did not exist, or

(B) If the lower of rule applies, is exercised in a manner that is consistent with that rule.

(iii) *Right to a guaranteed payment of a fixed amount under section 707(c)*. The right to a guaranteed payment of a fixed amount under section 707(c) is the right to a guaranteed payment (within the meaning of section 707(c)) the amount of which is determined at a fixed rate (including a rate that bears a fixed relationship to a specified market interest rate). A payment that is contingent as to time or amount is not a guaranteed payment of a fixed amount.

(iv) *Non-lapsing conversion right*—(A) *Corporations*. A non-lapsing conversion right, in the case of a corporation, is a non-lapsing right to convert an equity interest in a corporation into a fixed number or a fixed percentage of shares of the same class as the transferred interest (or into an interest that would be of the same class but for non-lapsing differences in voting rights), that is subject to proportionate adjustments for changes in the equity ownership of the corporation and to adjustments similar to those provided in section 2701(d) for unpaid payments.

(B) *Partnerships*. A non-lapsing conversion right, in the case of a partnership, is a non-lapsing right to convert an equity interest in a partnership into

a specified interest (other than an interest represented by a fixed dollar amount) of the same class as the transferred interest (or into an interest that would be of the same class but for non-lapsing differences in management rights or limitations on liability) that is subject to proportionate adjustments for changes in the equity ownership of the partnership and to adjustments similar to those provided in section 2701(d) for unpaid payments.

(C) *Proportionate adjustments in equity ownership.* For purposes of this paragraph (b)(4), an equity interest is subject to proportionate adjustments for changes in equity ownership if, in the case of a corporation, proportionate adjustments are required to be made for splits, combinations, reclassifications, and similar changes in capital stock, or, in the case of a partnership, the equity interest is protected from dilution resulting from changes in the partnership structure.

(D) *Adjustments for unpaid payments.* For purposes of this paragraph (b)(4), an equity interest is subject to adjustments similar to those provided in section 2701(d) if it provides for—

(1) Cumulative payments;

(2) Compounding of any unpaid payments at the rate specified in § 25.2701-4(c)(2); and

(3) Adjustment of the number or percentage of shares or the size of the interest into which it is convertible to take account of accumulated but unpaid payments.

(5) *Controlled entity*—(i) *In general.* For purposes of section 2701, a controlled entity is a corporation or partnership controlled, immediately before a transfer, by the transferor, applicable family members, and any lineal descendants of the parents of the transferor or the transferor's spouse. See § 25.2701-6 regarding indirect holding of interests.

(ii) *Corporations*—(A) *In general.* In the case of a corporation, control means the holding of at least 50 percent of the total voting power or total fair market value of the equity interests in the corporation.

(B) *Voting rights.* Equity interests that carry no right to vote other than on liquidation, merger, or a similar event are not considered to have voting

rights for purposes of this paragraph (b)(5)(ii). Generally, a voting right is considered held by an individual to the extent that the individual, either alone or in conjunction with any other person, is entitled to exercise (or direct the exercise of) the right. However, if an equity interest carrying voting rights is held in a fiduciary capacity, the voting rights are not considered held by the fiduciary, but instead are considered held by each beneficial owner of the interest and by each individual who is a permissible recipient of the income from the interest. A voting right does not include a right to vote that is subject to a contingency that has not occurred, other than a contingency that is within the control of the individual holding the right.

(iii) *Partnerships.* In the case of any partnership, control means the holding of at least 50 percent of either the capital interest or the profits interest in the partnership. Any right to a guaranteed payment under section 707(c) of a fixed amount is disregarded in making this determination. In addition, in the case of a limited partnership, control means the holding of any equity interest as a general partner. See § 25.2701-2(b)(4)(iii) for the definition of a right to a guaranteed payment of a fixed amount under section 707(c).

(6) *Qualified payment right*—(i) *In general.* A qualified payment right is a right to receive qualified payments. A qualified payment is a distribution that is—

(A) A dividend payable on a periodic basis (at least annually) under any cumulative preferred stock, to the extent such dividend is determined at a fixed rate;

(B) Any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount; or

(C) Any distribution right for which an election has been made pursuant to paragraph (c)(2) of this section.

(ii) *Fixed rate.* For purposes of this section, a payment rate that bears a fixed relationship to a specified market interest rate is a payment determined at a fixed rate.

(c) *Qualified payment elections*—(1) *Election to treat a qualified payment right*

as other than a qualified payment right. Any transferor holding a qualified payment right may elect to treat all rights held by the transferor of the same class as rights that are not qualified payment rights. An election may be a partial election, in which case the election must be exercised with respect to a consistent portion of each payment right in the class as to which the election has been made.

(2) *Election to treat other distribution rights as qualified payment rights.* Any individual may elect to treat a distribution right held by that individual in a controlled entity as a qualified payment right. An election may be a partial election, in which case the election must be exercised with respect to a consistent portion of each payment right in the class as to which the election has been made. An election under this paragraph (c)(2) will not cause the value of the applicable retained interest conferring the distribution right to exceed the fair market value of the applicable retained interest (determined without regard to section 2701). The election is effective only to the extent—

(i) Specified in the election, and
 (ii) That the payments elected are permissible under the legal instrument giving rise to the right and are consistent with the legal right of the entity to make the payment.

(3) *Elections irrevocable.* Any election under paragraph (c)(1) or (c)(2) of this section is revocable only with the consent of the Commissioner.

(4) *Treatment of certain payments to applicable family members.* Any payment right described in paragraph (b)(6) of this section held by an applicable family member is treated as a payment right that is not a qualified payment right unless the applicable family member elects (pursuant to paragraph (c)(2) of this section) to treat the payment right as a qualified payment right. An election may be a partial election, in which case the election must be exercised with respect to a consistent portion of each payment right in the class as to which the election has been made.

(5) *Time and manner of elections.* Any election under paragraph (c)(1) or (c)(2) of this section is made by attaching a

statement to the Form 709, Federal Gift Tax Return, filed by the transferor on which the transfer is reported. An election filed after the time of the filing of the Form 709 reporting the transfer is not a valid election. An election filed as of April 6, 1992, for transfers made prior to its publication is effective. The statement must—

(i) Set forth the name, address, and taxpayer identification number of the electing individual and of the transferor, if different;

(ii) If the electing individual is not the transferor filing the return, state the relationship between the individual and the transferor;

(iii) Specifically identify the transfer disclosed on the return to which the election applies;

(iv) Describe in detail the distribution right to which the election applies;

(v) State the provision of the regulation under which the election is being made; and

(vi) If the election is being made under paragraph (c)(2) of this section—

(A) State the amounts that the election assumes will be paid, and the times that the election assumes the payments will be made;

(B) Contain a statement, signed by the electing individual, in which the electing individual agrees that—

(1) If payments are not made as provided in the election, the individual's subsequent taxable gifts or taxable estate will, upon the occurrence of a taxable event (as defined in § 25.2701-4(b)), be increased by an amount determined under § 25.2701-4(c), and

(2) The individual will be personally liable for any increase in tax attributable thereto.

(d) *Examples.* The following examples illustrate provisions of this section:

Example 1. On March 30, 1991, P transfers non-voting common stock of X Corporation to P's child, while retaining \$100 par value voting preferred stock bearing a cumulative annual dividend of \$10. Immediately before the transfer, P held 100 percent of the stock. Because X is a controlled entity (within the meaning of paragraph (b)(5) of this section), P's dividend right is a distribution right that is subject to section 2701. See § 25.2701-2(b)(3). Because the distribution right is an annual cumulative dividend, it is a qualified payment right. See § 25.2701-2(b)(6).

Example 2. The facts are the same as in *Example 1*, except that the dividend right is non-cumulative. P's dividend right is a distribution right in a controlled entity, but is not a qualified payment right because the dividend is non-cumulative. Therefore, the non-cumulative dividend right is valued at zero under § 25.2701-2(a)(2). If the corporation were not a controlled entity, P's dividend right would be valued without regard to section 2701.

Example 3. The facts are the same as in *Example 1*. Because P holds sufficient voting power to compel liquidation of X, P's right to participate in liquidation is an extraordinary payment right under paragraph (b)(2) of this section. Because P holds an extraordinary payment right in conjunction with a qualified payment right (the right to receive cumulative dividends), the lower of rule applies.

Example 4. The facts are the same as in *Example 1*, except that immediately before the transfer, P, applicable family members of P, and members of P's family, hold 60 percent of the voting rights in X. Assume that 80 percent of the vote is required to compel liquidation of any interest in X. P's right to participate in liquidation is not an extraordinary payment right under paragraph (b)(2) of this section, because P and P's family cannot compel liquidation of X. P's preferred stock is an applicable retained interest that carries no rights that are valued under the special valuation rules of section 2701. Thus, in applying the valuation method of § 25.2701-3, the value of P's preferred stock is its fair market value determined without regard to section 2701.

Example 5. L holds 10-percent non-cumulative preferred stock and common stock in a corporation that is a controlled entity. L transfers the common stock to L's child. L holds no extraordinary payment rights with respect to the preferred stock. L elects under paragraph (c)(2) of this section to treat the noncumulative dividend right as a qualified payment right consisting of the right to receive a cumulative annual dividend of 5 percent. Under § 25.2701-2(c)(2), the value of the distribution right pursuant to the election is the lesser of—

(A) The fair market value of the right to receive a cumulative 5-percent dividend from the corporation, giving due regard to the corporation's net worth, prospective earning power, and dividend-paying capacity; or

(B) The value of the distribution right determined without regard to section 2701 and without regard to the terms of the qualified payment election.

[T.D. 8395, 57 FR 4257, Feb. 4, 1992]

§ 25.2701-3 Determination of amount of gift.

(a) *Overview*—(1) *In general.* The amount of the gift resulting from any transfer to which section 2701 applies is determined by a subtraction method of valuation. Under this method, the amount of the transfer is determined by subtracting the values of all family-held senior equity interests from the fair market value of all family-held interests in the entity determined immediately before the transfer. The values of the senior equity interests held by the transferor and applicable family members generally are determined under section 2701. Other family-held senior equity interests are valued at their fair market value. The balance is then appropriately allocated among the transferred interests and other family-held subordinate equity interests. Finally, certain discounts and other appropriate reductions are provided, but only to the extent permitted by this section.

(2) *Definitions.* The following definitions apply for purposes of this section.

(i) *Family-held.* Family-held means held (directly or indirectly) by an individual described in § 25.2701-2(b)(5)(i).

(ii) *Senior equity interest.* Senior equity interest means an equity interest in the entity that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest.

(iii) *Subordinate equity interest.* Subordinate equity interest means an equity interest in the entity as to which an applicable retained interest is a senior equity interest.

(b) *Valuation methodology.* The following methodology is used to determine the amount of the gift when section 2701 applies.

(1) *Step 1—Valuation of family-held interest*—(i) *In general.* Except as provided in paragraph (b)(1)(ii) of this section determine the fair market value of all family-held equity interests in the entity immediately after the transfer. The fair market value is determined by assuming that the interests are held by one individual, using a consistent set of assumptions.

(ii) *Special rule for contributions to capital.* In the case of a contribution to